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Building a Constituency for Deficit Reduction

by

Maureen Farrow

and

William B.P. Robson

The run-up to the federal government's 1989 budget has again focused public attention on Canada's federal deficit and growing public debt. Economists, business groups, central bankers, and international organizations, as well as the C.D. Howe Institute, have called for deficit reduction. Rising interest rates, some poor monthly deficit figures, and recent pessimistic statements by the federal government have lent a new sense of urgency to the discussion.

The Institute believes that the federal government should recommit itself to addressing this issue in 1989. The time is right because the government is at the beginning of a renewed mandate and the economic expansion still appears sound. If the year passes without new measures to address Canada's fiscal challenge, an important opportunity will have been lost.

Awareness of the problems posed by continuing large federal deficits has increased over the past few years as various milestones have been passed. Yet Canadians generally are not well informed about the problem. Many believe that the deficit does not matter. Among those who are concerned, there is often confusion about terms and incomplete understanding of the relationships among government spending, taxing, and borrowing. Indeed, the deficit and debt numbers are so large that they can be difficult to grasp. These circumstances make a constructive approach to Canada's fiscal challenge more difficult.

But the problem should not be ignored. The federal government's borrowing requirements impose costs that threaten Canadians' future living standards. This inaugural *Fiscal Policy Monitor* examines the concepts and measurement of the federal deficit and debt, and takes a backward look at how Canada arrived at its present position. It then reviews the main reasons why Canadians should be concerned about the deficit, and assesses the risks Canada faces if the current situation is allowed to continue. The *Monitor* closes by urging the federal government to recommit itself to a sensible deficit-reduction path during the next four years, and by highlighting some features which the Institute believes should be included in the upcoming federal budget.

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Box 1

Glossary of Terms

Public Accounts	The principal financial reporting system used by the government to record its transactions.
Program Spending	Government expenditures on items other than gross debt-service charges.
Statutory Spending	Expenditures made under statutes specifying the purposes, amounts, and periods of time of the programs, in contrast to spending made under annual appropriations.
Budgetary Balance	The difference between the government's revenues and expenditures in a fiscal year.
Surplus	A positive budgetary balance, occurring when revenues in a fiscal year are greater than expenditures.
Deficit	A negative budgetary balance, occurring when revenues in a fiscal year are less than expenditures.
Gross Public Debt	The government's total liabilities, mostly marketable bonds, Canada Savings Bonds, and treasury bills.
Net Public Debt	The difference between the gross public debt and the government's financial assets. This amount is equal to the accumulated federal budgetary balances.
Gross Debt-Service Charges	The cost of servicing the government's total liabilities. This amount is mostly interest payments, but also contains costs related to the management of debt securities.
Return on Investments	Income received by the government on its financial assets, mostly remittances from Crown corporations.
Net Debt-Service Charges	The difference between gross debt-service charges and return on investments. This amount represents the cost of servicing the net public debt.
Primary Balance	The budgetary balance excluding net debt-service charges.

Deficit reduction can be painful and acrimonious. The process will be easier if Canadians can reach a greater degree of consensus about the need for change, the appropriate objectives, and the right paths to take.

Understanding the Deficit and the Debt

One obstacle to an informed discussion of Canadian fiscal policy arises from confusion about terminology. To understand the deficit and the debt, a good starting point is a brief review of government spending, taxation, and borrowing. A glossary of the principal terms is provided in Box 1.

The Deficit and the Debt: Some Definitions

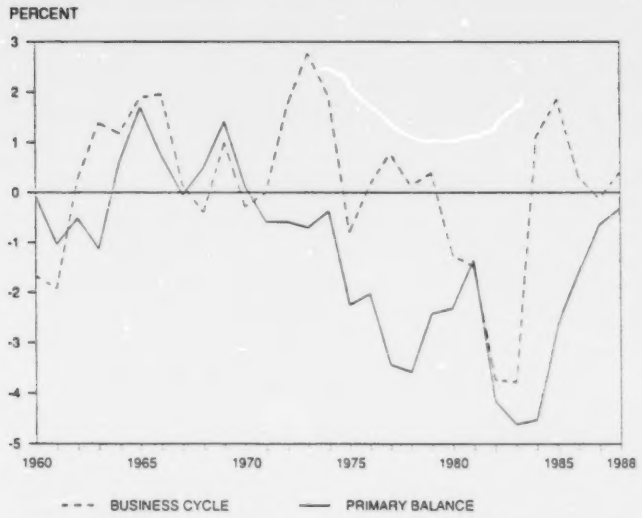
The federal government plays a key role in Canada's economy. Each year, the government spends tens of billions of dollars on transfer payments and purchases of goods and services. It raises the money to pay for these activities from a variety of sources, such as taxes on personal income and corporate profits.

It is not necessary — or appropriate — for the federal government's revenue to match spending exactly in every year, any more than it is necessary for an individual to earn every dollar that he or she spends in a year. Both the government and individuals can borrow to cover revenue shortfalls. When the government borrows, it records a deficit in its accounts. Lenders then expect to receive interest on their loans and, ultimately, to be repaid. In an important sense, therefore, a deficit represents taxes that were not levied immediately but were deferred through borrowing.

When the government borrows to finance a deficit, it creates financial claims on itself — mostly in the form of treasury bills and bonds — that are held by lenders. Deficits increase these liabilities relative to the government's financial

Figure 1

The Business Cycle and the Primary Balance, 1960–88[a]



[a]The business cycle is represented by deviations in the growth rate of real GDP per person, measured over two-year spans, from its trend since 1950. The primary balance is expressed as a percentage of GDP.

Sources: Department of Finance, *The Fiscal Plan* (Ottawa, February 1988); Statistics Canada, *Income and Expenditure Accounts*.

assets. The difference between the government's liabilities and its financial assets is the net public debt. The net public debt thus is equal to the sum of all the deficits, less all the surpluses, ever run by the federal government — or, to continue with the earlier analogy, the cumulative amount of all deferred taxes. The government must pay interest on this debt and must bear the costs associated with the issuing and retiring of bonds and treasury bills. This component of expenditure, known as public debt-service charges, represents the cost of carrying the debt.

When the public debt gets large, as is now the case in Canada, debt-service charges become a significant portion of expenditures and have a major influence on the overall budget balance. This element of spending is dictated for the most part by the size of already-existing debt and by interest rates — which, in turn, are strongly influenced by international developments. It is, therefore, largely out of the government's control from year to year. In order to get a clearer picture of the parts of the budget that the government can control, it is useful to remove net public debt charges from the total balance. This then reveals what spending and revenue would look like if the net public debt were zero — a concept known as the primary balance.

The Deficit, Past and Present

Armed with these concepts, one can now examine how the federal government reached its current situation. It is normal and, most economists would agree, desirable for the federal budget balance to fluctuate over the business cycle, moving into surplus when the economy is strong and into deficit when the economy is weak. Ideally, this "countercyclical" fiscal policy helps to stabilize the economy, smoothing out peaks and troughs in economic growth. To a considerable extent, federal stabilization is automatic: several important sources of government revenue are buoyant during economic booms and weak when the economy is slow, while the reverse is true of elements of spending, such as income support, which tend to rise during slowdowns or recessions, and fall in more prosperous times.

The relationship between the primary budget balance, expressed as a proportion of gross domestic product (GDP), and the business cycle is shown in Figure 1. During the 1960s, the primary balance tended to reflect the state of the economy quite closely. This relationship started to break down in the 1970s, however, as social programs were enriched and numerous tax breaks were introduced or enlarged. As a result, the primary balance moved into a bigger deficit than the state of the economy would have led one to expect and, during the second half of the 1970s, federal fiscal policy tended to reinforce, rather than reduce, fluctuations in growth rates.

During the 1980s, the previous relationship between the primary balance and the business cycle has been partially restored. The severe 1981–82 recession pushed the primary balance well into deficit. Since 1984, economic growth has been relatively strong, and the normal impact of a healthy economy on revenue and spending,

Table 1

Federal Budget Balances, Net Debt Charges and Net Debt, fiscal years 1978–79 to 1988–89[a]

($ billions)

Fiscal year	Primary deficit	Net debt charges	Total deficit	Net debt (year-end)	Net debt as % of GDP
1978–79	8.7	4.0	12.6	60.7	25.1%
1979–80	6.7	4.8	11.5	72.2	26.1
1980–81	7.2	6.3	13.5	85.7	27.6
1981–82	4.8	10.1	14.9	100.6	28.2
1982–83	15.5	12.3	27.8	128.4	34.3
1983–84	18.7	13.7	32.4	160.8	39.6
1984–85	20.1	18.2	38.3	199.1	44.8
1985–86	12.7	21.7	34.4	233.5	48.8
1986–87	8.2	22.4	30.6	264.1	52.1
1987–88	3.6	24.5	28.1	292.2	53.2
1988–89	2.0	27.0	28.9	321.1	53.6

[a]Data for fiscal year 1988–89 are as forecast in February 1988.

Sources: Department of Finance, *The Fiscal Plan* (Ottawa, February 1988); Statistics Canada, *Income and Expenditure Accounts.*

along with selective expenditure restraint and tax increases, has brought the balance back toward zero — though not as quickly as the strength of the recovery would have suggested. The primary deficit is expected to have declined to about 0.3 percent of GDP in fiscal year 1988–89 from 4.6 percent in 1983–84.

The Growth of Debt and Debt-Service Costs

The current fiscal difficulty arises from the federal government's having run consistent primary deficits — deferring taxation to the future — for a decade and a half, and accumulating an increasingly burdensome debt load. Table 1 shows primary deficits, net debt charges, total deficits and the mounting net debt over the past ten years. It is evident from the table that constant borrowing has caused debt-service charges to account for a growing share of the total deficit. The net debt was projected in the February 1988 budget to be more than five times higher at the end of fiscal year 1988–89 than it had been ten years earlier. As the debt has grown and interest rates have risen, the cost of servicing the debt has grown even more rapidly — almost sevenfold.

When the debt and debt-service charges are shown in relation to the economy, as in Figure 2, the increase is not so large, but it is still significant. After edging up during the second half of the 1970s from its trough in fiscal year 1974–75 (less than 17 percent of GDP), federal net debt rose dramatically in relation to the size of the economy in the 1980s. Although the increase in this ratio has slowed since 1985, the figure at the end of 1988–89 is expected to be some 53.6 percent of GDP, twice as large as at the beginning of the decade.

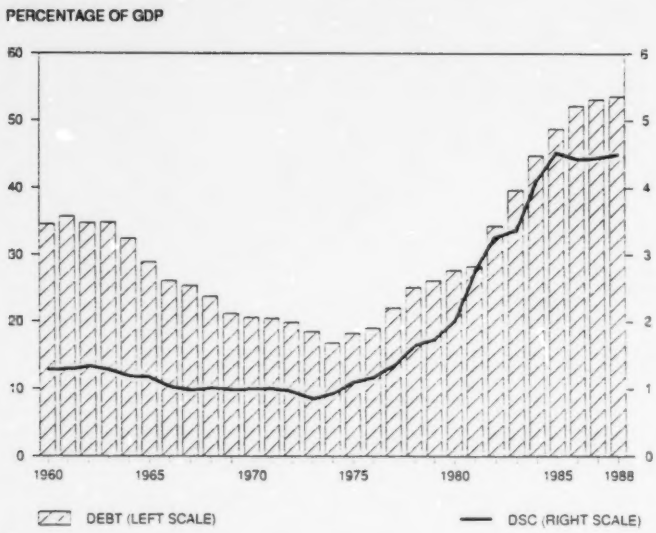
Higher interest rates have caused net debt-service charges to rise even more quickly. After averaging around 1 percent of GDP in the early 1970s, net debt charges rose to 2 percent of GDP by 1980. In recent years, the proportion of GDP being absorbed by the government's debt-service costs has more than doubled from the level at the beginning of the decade, averaging 4.5 percent.

The Latest Figures

The significance of these items in the total federal budget is shown in Table 2 (on page 6), which gives a summary of the federal government's budgetary transactions in the most

Figure 2

Net Federal Debt and Debt-Service Charges (DSC), 1960–88
(as a percentage of GDP)



Sources: Department of Finance, *The Fiscal Plan* (Ottawa, February 1988); Statistics Canada, *Income and Expenditure Accounts.*

recent fiscal year for which complete figures are available (April 1, 1987, to March 31, 1988). In fiscal year 1987–88, the government recorded $125.5 billion in budgetary expenditure — equal to about $4,900 per person or 22.8 percent of GDP. At $29 billion, public debt charges were more than 23 percent of the total — as much as all elderly benefits, unemployment insurance benefits, and Canada Assistance Plan transfers combined. The relative importance of various expenditure items is shown in Figure 3.

Budgetary revenues of $97.5 billion were sufficient to cover 10 out of every 13 dollars spent. The rest — the deficit of $28.1 billion, equal to some $1,100 per person or just over 5 percent of GDP — was not financed by taxation, but borrowed. The relative importance of each source of funds, including borrowing, in financing total expenditure is shown in Figure 4. This new borrowing raised the net public debt to $292.2 billion — over $11,400 per person or 53.2 percent of GDP — at year-end, from $264.1 billion at the beginning of the year. Subtracting net debt charges of $24.5 billion from the total deficit yields a primary deficit of $3.6 billion for the fiscal year.

The importance of debt service in federal expenditure for fiscal year 1988–89 will have been even greater. In the February 1988 budget, gross public debt charges for the fiscal year were forecast at some $32 billion, an increase of almost $10 billion from their level in fiscal year 1984–85, when the Conservative government first took power. The rising bill for the deferred taxes of past years has accounted for more than 40 cents of every dollar of new federal spending since then. As Figure 5 shows, only the much more sizable social development envelope was forecast to show a dollar increase anything like as large. (In percentage terms, the difference is far more dramatic: debt-service costs were estimated to have risen by 43 percent, compared with 17 percent for all social development spending and 13 percent for all other expenditures.)

Progress in reducing the total deficit has recently stalled, as Figure 6 illustrates. This is largely the result of the growth of debt-service charges. Almost 15 years of sizable borrowing by federal governments has resulted in debt-service charges that are, by themselves, sufficient to ensure continued large borrowings for the foreseeable future. In fact, the coming fiscal year is likely to be something of a milestone in Canadian federal fiscal history: the government expects to record its first primary surplus since fiscal year 1970–71. This accomplishment, however, will be overshadowed somewhat by a total deficit that — in the absence of new measures — will again be close to $30 billion. Large deficits, mounting debt, and rising interest payments have developed a momentum that is increasingly difficult to fight.

Why Should Canadians Be Concerned about the Deficit?

There are three types of risks associated with continued high levels of government borrowing that should be of concern to all Canadians.[1] First, when interest payments make up a growing share of government spending, the government's fiscal flexibility — that is, its ability to change policies in response to changed circumstances —

Table 2

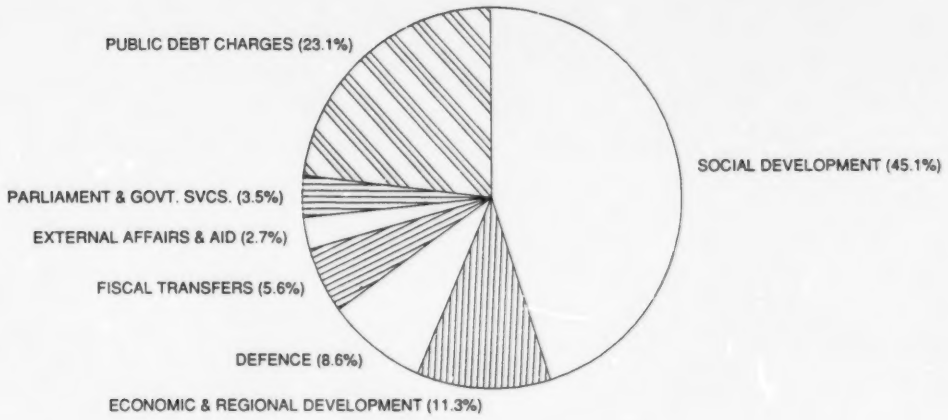
Federal Budgetary Transactions, fiscal year 1987–88

	$ billions	% of Total expenditure	$ per person	Percent of GDP
Expenditure				
Social development	$56.6	45.1%	$2,210	10.3%
Elderly benefits	14.3	11.4	560	2.6
Unemployment insurance benefits	10.5	8.4	409	1.9
Established Programs Financing transfers	8.8	7.0	343	1.6
Canada Assistance Plan	4.2	3.4	166	0.9
Family allowances	2.6	2.0	100	0.5
Other	16.2	12.9	632	2.9
Economic & regional development	14.2	11.3	555	2.6
Defence	10.8	8.6	420	2.0
Fiscal arrangements	7.0	5.6	273	1.3
External affairs & aid	3.4	2.7	134	0.6
Parliament & services to government	4.4	3.5	173	0.8
Total program expenditure	96.5	76.9	3,766	17.6
Public debt charges	29.0	23.1	1,133	5.3
Total expenditure	*125.5*	*100.0*	*4,899*	*22.8*
Revenue				
Personal income tax	45.1	35.9	1,761	8.2
Corporate profits tax	10.9	8.7	425	2.0
Unemployment insurance contributions	10.4	8.3	407	1.9
Sales tax	12.9	10.3	504	2.4
Import duties	4.4	3.5	171	0.8
Energy taxes	2.6	2.1	102	0.5
Miscellaneous revenue	6.6	5.2	256	1.2
Return on investments	4.5	3.6	177	0.8
Total revenue	*97.5*	*77.6*	*3,803*	*17.7*
Deficit	*28.1*	*22.4*	*1,096*	*5.1*
Net public debt				
at beginning of year	264.1	—	10,306	52.1
at end of year	292.2	—	11,402	53.2
Memorandum items				
Expenditure subtotals				
Statutory expenditure	84.9	67.7	3,314	15.5
Nonstatutory expenditure	40.6	32.3	1,584	7.4
Major transfers to provinces	20.1	16.0	783	3.6
Public debt charges	29.0	—	1,133	5.3
Less return on investments	4.5	—	177	0.8
Equals net debt charges	*24.5*	—	*955*	*4.5*
Deficit	28.1	—	1,096	5.1
Less net debt charges	24.5	—	955	4.5
Equals primary deficit	*3.6*	—	*141*	*0.7*

Sources: Receiver General for Canada, *Public Accounts of Canada* (Ottawa, 1988); Statistics Canada, *Income and Expenditure Accounts*.

Figure 3

Budgetary Expenditures, fiscal year 1987–88



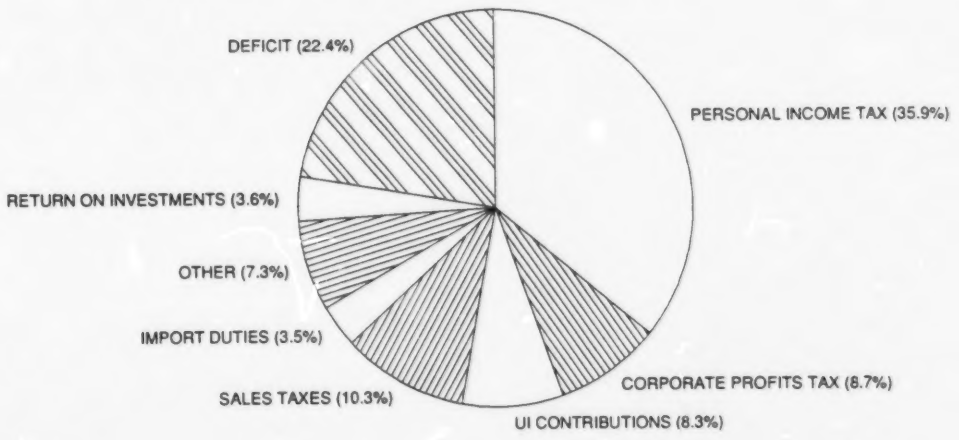
Source: Receiver General for Canada, *Public Accounts of Canada* (Ottawa, 1988).

becomes restricted. Second, continued large deficits can increase inflationary pressure and, particularly if they lead to fears of easier monetary policy, may push interest rates up. Third, Canadians' future living standards may be reduced if government borrowing for current consumption absorbs saving and lowers the country's future stock of physical assets and net investment abroad.

Ignoring the accumulation of federal debt in setting fiscal policy involves an implicit assumption that future Canadians will be so much wealthier than the present generation that these added costs will be easy to bear. If economic cir-

Figure 4

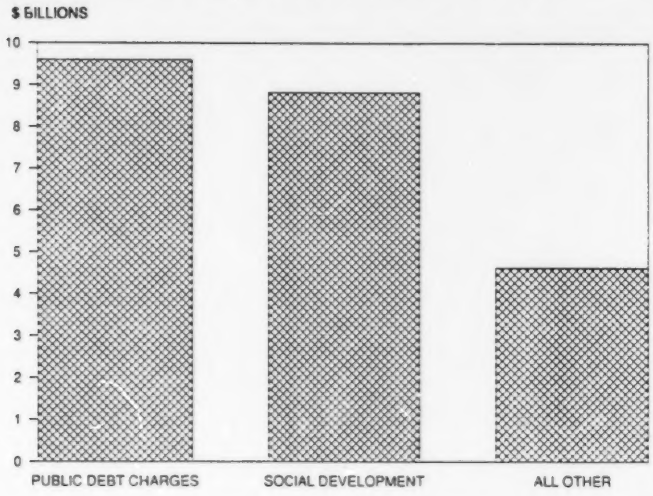
Financing of Budgetary Expenditures, fiscal year 1987–88



Source: Receiver General for Canada, *Public Accounts of Canada* (Ottawa, 1988).

Figure 5

Changes in Federal Expenditures by Spending Envelope, fiscal years 1984–85 to 1988–89[a]



[a]Data for 1988–89 are estimates.

Sources: Department of Finance, *1988–89 Estimates*; Receiver General for Canada, *Public Accounts of Canada* (Ottawa, 1988).

cumstances in coming years turn out to be less favorable, however, the impact on future Canadians could prove quite onerous.

The Loss of Fiscal Flexibility

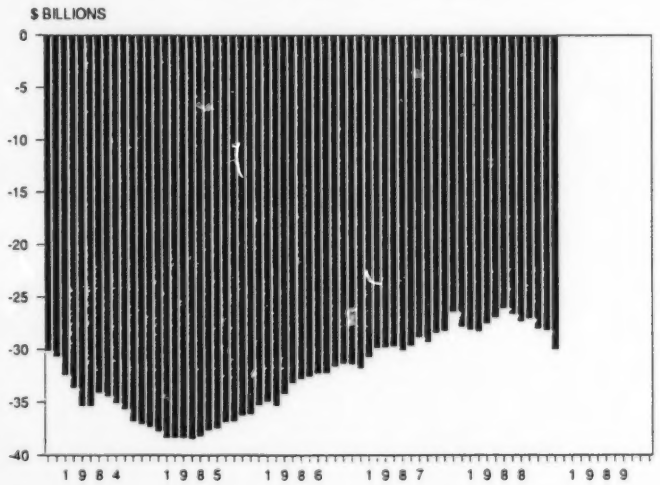
Canadians should be concerned about the growth of debt-service charges in federal spending. Interest payments are nondiscretionary. A large debt-service component renders spending less flexible. It gives an upward bias to the size of total government spending relative to the economy. It also limits the government's ability to meet new demands for public services and reduces its flexibility in stabilizing the economy during slowdowns. In addition, the larger the share of interest payments in government spending becomes, the more changes in interest rates can throw the government's plans off course.

The upward bias that accumulated deficits give to government spending is straightforward: every dollar borrowed means (at 10 percent interest rates) approximately 10 cents annually in interest payments until the debt is retired. Thus, $30 billion in deficit financing in one year raises the floor from which decisions about the overall size of government spending and revenues will be made in the next year by some $3 billion. The federal government's debt-service charges now amount to some $1,240 per person, up from $900 four years ago. In four more years, based on current trends, another $400 may be added to this amount. The collection of revenue to pay these charges is not painless: higher taxes tend to produce higher administration costs, higher compliance costs, and greater losses to the economy as a result of tax-related distortions.

In addition, debt-service charges have overshadowed other government priorities. The imperative to maintain revenue in the face of growing interest payments, for example, has ruled out

Figure 6

Federal Budget Balance, 1984–89
(estimated 12-month running total)



Sources: Receiver General for Canada, *Statements of Financial Operations* (various issues); C.D. Howe Institute estimates.

Box 2

GDP Growth, Interest Rates, and the Debt-to-GDP Ratio

A government that wishes to contain the burden of public debt charges on the economy has to focus on controlling the debt-to-GDP ratio. Stabilizing this ratio, by getting the growth rate of the debt down to the point where it is no faster than the growth of GDP, has been one of the key features of the Progressive Conservative government's fiscal plan.*

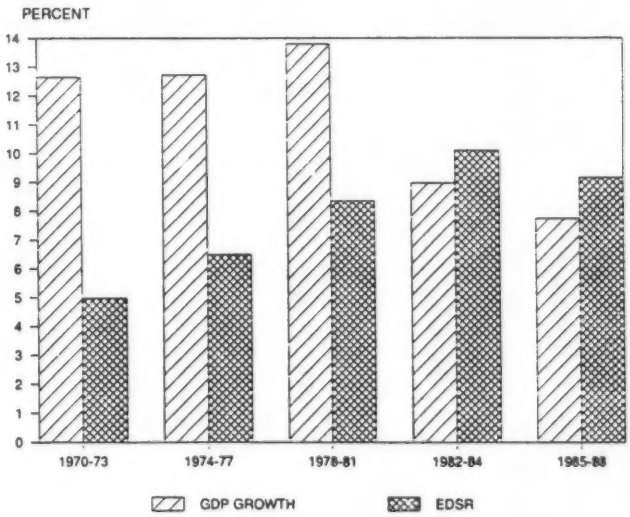
The task of stabilizing the debt-to-GDP ratio has been made more difficult, however, by the changing relationship between growth of GDP and interest rates. Nominal GDP growth and the government's effective debt-service rate are illustrated in the accompanying figure. When the budget is in primary balance and GDP growth rates are higher than interest rates, the economy will grow faster than the debt and the debt-to-GDP ratio will fall. When GDP growth rates are lower than interest rates, on the other hand, the cost of servicing the already-existing debt will, by itself, be large enough to cause the debt to grow faster than the economy.

In the early 1970s, GDP growth exceeded the effective debt-service rate by a wide margin. As a result, the debt-to-GDP ratio declined during those years, even though the government ran small primary deficits. In the second half of the 1970s, larger deficits and a narrowing gap between nominal growth and the effective debt-service rate brought about a reversal, with the debt ratio edging up to 28 percent by 1981. Since the 1981-82 recession, when the primary deficit ballooned, the situation has been much less favorable: the effective debt-service rate has exceeded the growth of the economy. This is why the debt-to-GDP ratio has risen so sharply.

It seems likely that this unfavorable combination of growth rates and debt-service rates will persist for the foreseeable future. If this is so, even with a primary balance of zero, the debt-to-GDP ratio will rise without limit. To keep the debt-to-GDP ratio stable, the government will need to run sizable primary surpluses.

* The reference here is to nominal, or current-dollar (as opposed to real, or constant-dollar) GDP.

GDP Growth and the Federal Government's Effective Debt-Service Rate (EDSR), 1970–73 to 1985–88
(percent, annual averages)



Sources: Department of Finance, *The Fiscal Plan* (Ottawa, 1988); Statistics Canada, *Income and Expenditure Accounts.*

serious consideration of potentially beneficial changes in Canada's tax system — such as the adjustment, for tax purposes, of interest and capital gains income for inflation.[2] On the spending side, the government is now being forced to reconsider some of the promises made during the election campaign.

The federal government's increased vulnerability to interest-rate changes is evident in the fact that current higher-than-expected interest rates have put the medium-term fiscal plan announced in the February 1988 budget under severe pressure. The plan called for total spending to rise to $147.8 billion in fiscal year 1992–93, an increase of $15.5 billion from the estimated 1988–89 level. But recent levels of interest rates — depending on the government's management of its liabilities — could cause gross public debt

Box 3

The Debt-to-GDP Ratio in Historical Perspective

It is sometimes suggested that the federal government's fiscal position is not serious compared with the situation that occurred during World War II, when the ratio of net federal debt to GDP rose to over 100 percent. There are, however, two key differences between Canada's position then and now.

First, between 1944 and 1948, federal spending fell by some 63 percent , as a result of the winding down of the wartime military effort. (Military spending, which is politically relatively painless to cut, accounted for over 80 percent of federal spending in 1944.) This dramatic drop in spending meant that, in the following decade, the net debt was actually *reduced* by a series of budget surpluses. The prospect of any substantial reduction — let alone a plunge of almost two thirds — in federal spending over the next four years seems remote.

Second, the government's effective debt-service rate (the ratio of net public debt charges to net public debt) in the immediate postwar period was 3.1 percent. Today, the figure is roughly three times as high. Today's debt-to-GDP ratio may be below the wartime peak, but the burden of federal debt service on the economy has already surpassed the World War II level because of the much higher cost of servicing today's debt.

charges to rise by more than $12 billion over the next four years. For the government to keep to its overall expenditure target, growth of program spending would have to be held to not much more than $3 billion — about one-quarter the increase recorded during the Conservative government's 1984-88 term.

Interest payments are beginning to put the federal government into a fiscal straitjacket. As long as the debt continues to grow faster than the economy, the government's freedom to maneuver will shrink (see Box 2). In future, Canadians may desire increased federal expenditures in such areas as the environment, labor training, and science and technology. In the event of a slowdown or recession — an important possibility at this stage in the business cycle — the federal government will be expected to cushion the downturn by allowing its revenues to fall off and by increasing its spending on income support. It will be more difficult for the government to act in these areas if debt-service charges are allowed to add a growing prior claim to future revenues. This is a key reason why Canadians should recognize the necessity for the government to recommit itself to putting its fiscal house in order (see Box 3).

The Threat of Inflation and Higher Interest Rates

Persistent high deficits can bring about a self-reinforcing cycle of increased inflationary pressure, increased inflationary expectations, and higher interest rates. A number of factors are at work in this phenomenon, but the end result is that persistent, large government deficits make the Bank of Canada's task of restraining inflation more difficult. If it is perceived that the Bank's difficulties will increase in the future, fears of a future loosening of monetary policy will cause investors to demand an inflation-risk premium on their loans, pushing interest rates up now.

Deficits are likely to add to inflationary pressure when an economy is operating close to full employment. The fiscal stimulus may add to demand, but supply cannot respond because unemployment is low and bottlenecks are becoming widespread. The result, particularly in areas of the economy where imports cannot fill the gap, tends to be upward pressure on prices. If the central bank resists this tendency, short-term interest rates will rise.

Inflationary forces may also be aggravated by the impact of government debt on the money supply. The possibility exists that the central bank will buy and hold a large proportion of the debt with newly created money (this is what is meant by "monetizing" the deficit). The Bank of Canada's uptake of federal debt, however, has been quite modest in recent years. Of concern to some financial market participants at present is the potential boost to liquidity in the economy when the government issues large amounts of short-term government debt that can be regarded as a good substitute for money, such as Canada Savings Bonds and treasury bills. To the extent that this debt facilitates faster growth of spending power in the economy, it would further complicate the Bank's task of containing inflation.

Persistent government borrowing can push interest rates up directly, as investors demand in-

creasingly favorable returns on government debt to compensate them for holding more of it in their portfolios than they otherwise would want. In any event, higher interest rates make the lives of debtors — the government included — more difficult. In some circumstances, this can lead to political pressure on the central bank to ease its policy and allow the money supply to grow more quickly.

There are strong signals that inflationary pressure is building in the Canadian economy. Final domestic demand expanded by 5.1 percent in 1988, faster than the long-term potential growth rate of output. At the beginning of 1989, the unemployment rate was close to its lowest point since the peak of the last business cycle, while the employed proportion of the population was at its highest level ever. These pressures are showing up in higher wage settlements and in an acceleration of inflation: the Consumer Price Index, excluding food and energy, was up 5.4 percent year-over-year at the beginning of 1989, compared with a 4.3 percent figure a year earlier. Most economists agree that the Bank of Canada's task of containing and reducing inflation would be easier and smoother if fiscal policy were more restrictive.

The threat of higher inflation as a result of the deficit has important consequences. Many lenders suffered severe losses when inflation accelerated unexpectedly in the 1970s, and financial markets are now acutely sensitive to the prospect that the same thing might happen again. As a result — whether these fears are justified or not — Canadian interest rates now appear to contain a significant inflation-risk premium. During the 1984–88 period, both short- and long-term interest rates have exceeded the rate of inflation by about 6 percent — a sustained high level of "real" interest rates that is without precedent in Canadian history.

The Bank of Canada's firmness in containing inflation has a subduing effect on long-term interest rates. In the presence of continued large federal deficits, however, investors are fearful enough of future changes in Bank policy to limit this effect. This is an important element in the uncomfortable "accelerator-brake" fiscal/monetary policy mix that Canada, like the United States, has experienced in recent years. A significant cut in the federal deficit would help to allay these fears, and would put the Bank in a position to allow short-term rates to retrace some of their recent advance once evidence of containment of inflation was clear.

The fact that Canadian real interest rates are high is already well appreciated by mortgage holders, users of consumer credit, businesses looking to finance capital investments, and farmers. All Canadians should be concerned about the contribution that government deficits are making to fears about accelerating inflation and to higher interest rates. Deficit reduction has an important role to play in containing inflation and slowing economic activity to sustainable levels, thus allowing interest rates to come down.

The Impact on Net Wealth Formation

A complex issue, but one with important implications for Canadians' future living standards, is the impact of government borrowing on Canadian capital investment and foreign indebtedness. The rate at which Canada builds up its stock of income-producing wealth — in the form of plant and equipment, investment abroad, and housing — is a critical determinant of Canadians' future incomes. If saving that would otherwise have gone into net wealth formation is diverted into current consumption by government borrowing, Canada's future standard of living will be lower.[3]

The possibility that government borrowing will lower private domestic capital investment is often referred to as "crowding out". In a closed economy with no access to foreign capital, every time someone with savings to invest buys a government bond, nongovernment borrowers — who might want to build houses, factories, or mines — will have to operate with less. Canada is, of course, open to foreign capital flows. If the combined demands of government borrowing for consumption and domestic capital investment exceed domestic saving, foreign lenders fill the gap. This, however, creates another problem: higher foreign indebtedness. Canada's future stock of physical capital — and output from it — may be as high as it would have been in the absence of government borrowing, but the returns to Canadians from their productive efforts will be reduced by a larger stream of dividend and interest payments to foreigners. In either case, government borrowing that is not offset by a

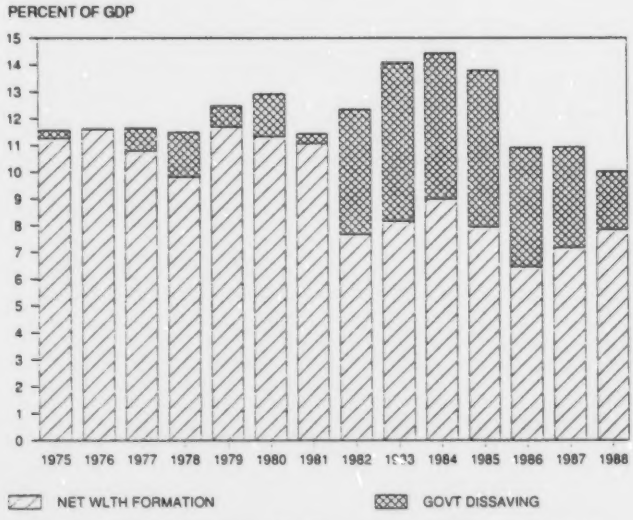
higher level of private saving reduces Canada's future stock of Canadian-owned income-producing wealth.

Because the Canadian economy is relatively small and international capital is mobile, the impact of government borrowing on domestic capital investment has probably not been large. Canada's reliance on foreign saving, however, has increased significantly in recent years. The dependence of the federal government itself on foreign funds is evident from the growth of the proportion of the government's debt that is held by non-residents. Between the end of 1984 and the end of September 1988, federal securities and loans outstanding increased by $97.4 billion. Of this amount, some $27.3 billion — over 28 percent — was accounted for by net increases in the holdings of nonresidents. In other words, more than one out of every four new dollars borrowed by the federal government since the end of 1984 came from foreigners. This trend toward greater dependence on foreign lenders has become more pronounced over time: in the first three quarters of 1988, increases in nonresident holdings amounted to almost two thirds of the total increase in debt.

Figure 7

The Disposition of Net Private Saving: Government Dissaving versus Net Wealth Formation, 1975–88

(as a percentage of GDP)



Source: Statistics Canada, *Income and Expenditure Accounts*.

Paralleling the growth of foreign holdings of federal debt has been Canada's increasing reliance on foreign lenders to finance a shortfall of domestic saving. Over the past four years, foreign borrowing has filled a gap of over $45 billion between Canada's domestic saving and domestic demand for funds. Part of this amount has been offset by unilateral transfers such as money brought into the country by immigrants. For the most part, however, this borrowing has added to Canada's net external liabilities, which stood at almost $230 billion at the end of 1988. Servicing this debt requires a rising stream of payments to foreigners, meaning that fewer of the rewards of their productive efforts are available to Canadians. The net outflow of interest and dividends to foreigners in 1988 amounted to over $18.4 billion — more than $700 per person.

It is also important to remember that foreign lenders do not make money available simply because Canadians need it. They have to be offered attractive returns, in the form of higher interest rates in Canada relative to interest rates in other countries than would otherwise exist. Wider interest-rate spreads have a buoying effect on the Canadian dollar, hurting Canada's exporting and import-competing industries and helping to produce the current account deficit that is — as U.S. experience has highlighted during the 1980s — the counterpart of dependence on inflows of foreign capital. It is likely that both interest rates and the Canadian dollar would be lower if Canada's dependence on foreign lenders was less.

An impression of the interaction between public-sector borrowing for current consumption and net wealth formation — domestic capital investment and changes in net foreign assets considered together — can be gained from Figure 7. The total height of each bar represents net private saving (as a proportion of GDP), while the shaded portions identify the amount that was absorbed by government borrowing for current consumption (often called dissaving), and the amount that went into net wealth formation.[4]

During the second half of the 1970s, federal dissaving tended largely to be offset by surpluses in the rest of the public sector. On average, public-sector borrowing for current consumption absorbed only about one in 20 dollars of net private

Box 4

Estimating the Deficit's Impact on Net Wealth Formation

How much difference has public-sector borrowing for current consumption made to Canadian net wealth formation? This question is not easy to answer with confidence, because it is difficult to say what private saving behavior would have been like if the government's demand for funds had been smaller. Government borrowing may affect private saving both through its influence on total demand and through its impact on consumers' perceptions of future tax liabilities.

The size of this response is critical. If private saving does not react at all, public-sector borrowing will be reflected dollar-for-dollar in a combination of lower capital investment and higher foreign borrowing. To the extent that private saving is higher in the presence of government borrowing, part of the government's demand for funds will be satisfied by new domestic saving, and the impact on net wealth formation will be smaller.*

If it is difficult to measure the reduction in wealth formation that government borrowing has caused, it is nevertheless important to realize that, because deficits have been so big in recent years, the total impact may be substantial. From 1985, the first full year of the Conservatives' first term, through 1988, the federal government borrowed close to $100 billion to finance current spending — equal to over 40 percent of net private-sector saving over the period.

If saving in the rest of the economy increased enough to accommodate half this amount — $50 billion — the rest would be reflected in $50 billion of foregone capital investment and increased foreign indebtedness.† Pick an average rate of return on foregone investment and on new foreign liabilities — say, 10 percent — and the loss to Canadian national income as a direct result of the last four years' borrowing would amount to some $5 billion annually, or almost $200 per person.

*Whether, and by how much, increased government borrowing is accommodated by increased private saving is a subject of considerable debate among economists. For this reason, the figures used in this box should be understood as being illustrative.

†A 50–50 split between increased private saving and reduced net wealth formation is consistent with some estimates that have been made for the United States. See Michael J. Boskin, *Reagan and the U.S. Economy: The Successes, Failures, and the Unfinished Agenda* (San Francisco: International Center for Economic Growth, 1987), pp. 191–192.

saving. The picture changed dramatically with the onset of recession in 1982, as the federal deficit ballooned and the surplus of the rest of the public sector contracted. From 1982 to 1985, government dissaving absorbed two out of every five dollars of private saving. Despite the fact that private saving rose sharply, the share of the economy that was devoted to net wealth formation was at its lowest level in over two decades. Since then, the amount of private saving borrowed by governments has fallen, but private saving itself has also slipped downward. As a result, the proportion of GDP directed into net wealth formation has been at historic lows (see Box 4).

Foregone capital investment, increased foreign liabilities, and the depressing effect of wider interest-rate spreads and a higher dollar on sensitive areas of the economy are all important considerations in setting fiscal policy. The possibility that government borrowing is absorbing the saving needed to enhance future living standards should be of concern to all Canadians.

Will Future Canadians Be Richer than We Are?

Ultimately, judgment on these issues depends on one's position with regard to the welfare of future Canadians. Will they be wealthy enough to bear the costs imposed by federal borrowing without significant hardship? If the future is bright and economic growth continues to be buoyant, and if the potential challenges to Canadians' future well-being posed by such factors as demographic shifts and environmental stresses turn out not to be serious, then the burdens of reduced fiscal flexibility and a lower stock of net wealth may not be difficult to shoulder.

It is certainly possible that future Canadians will be far better off than the current generation. Prudence demands, however, that risks to this outlook be taken into account. To begin with, the next generation will have to cope with far greater numbers of elderly: by the mid-twenty-first century, the proportion of elderly in Canada's population may well have doubled. Steady, rapid growth

of the world economy also should not be taken for granted. Coming decades may see renewed pressure on world food supplies from a rapidly rising global population. Another period of shortage for vital industrial commodities, particularly fossil fuels, cannot be ruled out. Last summer's drought — and the potential for a repetition this year — should serve as a reminder that environmental stresses may present a virtually unprecedented challenge to future living standards.

These or other, as yet unforeseen, developments may put downward pressure on future Canadians' well-being. This prospect should prompt the present generation to be careful not to reduce future Canadians' capacity to cope with such challenges by reducing the wealth at their disposal and by putting a large prior claim, in the form of debt-service charges, on future federal government revenues.

The Task Ahead

If the negative impact of continuing high deficits on future living standards is to be reduced, it is important that the federal government recommit itself immediately to the task of getting its fiscal house in order. A renewed mandate in November 1988 and an economic expansion that still appears healthy present the government with a favorable opportunity. At the same time, the impact of rising interest rates on debt-service costs provides a reminder that vigorous measures are needed if Canada is to regain control over its fiscal destiny.

The Next Budget

In order to put federal finances on a firm longer-term footing, it is essential that the federal government stabilize, and begin to make modest reductions in, the debt-to-GDP ratio by the end of the next four-year period. While such a program might not seem ambitious at first sight, it involves a larger shift in the primary balance over the next four years than was accomplished in the government's first term — into substantial surplus. As the Institute has argued in its most recent *Policy Review and Outlook*, a realistic goal would be to cut the total budget deficit to about $15 billion by the end of the next four years through annual reductions of $3 to $5 billion.[5] Barring a marked deterioration of economic performance, such a program would bring about a modest decline in the debt-to-GDP ratio by 1992. This is the sort of deficit target that the government should set in its upcoming budget.

Beyond the total figures projected for the deficit, there are a number of further considerations Canadians should bear in mind in judging the 1989 budget. First, does the government's fiscal plan have a sound basic orientation? Recent budgets have relied too much on tinkering, such as the acceleration of personal income tax remittances, in order to make near-term results look better. In the upcoming budget, the government needs to set more fundamental changes in motion.

Second, does the fiscal plan strike the right balance between expenditure restraint and the need for new revenue? On the expenditure side, there must at the very least be no new spending programs. Further longer-term cuts will have to be made in discretionary items, and some first steps must be made toward a restructuring of federal income-support programs. On the revenue side, the government will be forced to resort to tax increases. It is essential, however, that the resulting revenues be earmarked for

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Maureen Farrow is President of the C.D. Howe Institute, and William B.P. Robson is a Policy Analyst at the Institute.

For further information on Institute publications, please contact: Barry Norris, Director of Publications, C.D. Howe Institute, 125 Adelaide Street East, Toronto, Ontario M5C 1L7; telephone (416) 865-1904; fax (416) 865-1866.

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deficit reduction — and, preferably, identified as such with a special name. The government must clearly signal its intention to rescind the tax increases once its deficit-reduction targets are reached, rather than redirecting the revenues into a new, permanently higher level of program expenditures.

Third, does the fiscal plan appear fragile — that is, is it based on optimistic assumptions, leaving little room for slippage? The drought deficiency payments announced last fall for grain farmers serve as a reminder that fiscal plans are hostage to unforeseen setbacks. In recent years, economic performance has been consistently better than expected, yet the deficit has been regularly knocked upward by collapses in the price of oil and grain, debt forgiveness of Crown corporations and Third World borrowers, and higher interest rates. Indications of how the government intends to deal with events of this sort — let alone the possibility of a slowdown or recession — are important elements of a responsible fiscal plan.

Finally — and fundamentally — has the government laid out an agenda that is both comprehensive and comprehensible? The budget will need to articulate the government's intentions clearly, so that each constituency affected by expenditure and revenue changes can understand their importance in the overall fiscal plan. A credible commitment to put federal finances on a firmer footing requires the government to set out a course for which it can be held accountable. The basic directions, the respective contributions to be made by spending cuts and tax increases, and the sensitivity of the plan to contingencies should be presented in a straightforward manner against which future performance can be measured. And there must be a commitment to stay on course , despite the inevitable setbacks.

Fighting Complacency

The aim of this *Fiscal Policy Monitor* has been to explain the nature of the federal government's fiscal challenge, to indicate the costs that continued high deficits impose, and to show the direction that the C.D. Howe Institute believes the government needs to take over the next four years. These arguments need to be kept at the forefront of the debate over Canadian fiscal policy in the years ahead. The battle against complacency is one of the hardest and most critical that those concerned about Canada's fiscal situation have to fight. History gives no encouragement to the view that government borrowing will automatically be halted before it imposes major costs on a country's future well-being. In the 1980s, for example, Ireland has experienced the painful impact of past fiscal excesses. Ireland's public debt now exceeds the size of its economy. Capital investment has fallen for six straight years, real consumer spending is below its level at the beginning of the decade, and unemployment is close to 20 percent. Countries have blundered their way into hardship time and again.

Canada's own recent history is instructive. In the fall of 1984, a newly elected government with an overwhelming majority presented the case for fiscal consolidation in strong and persuasive terms. In his November 1984 economic statement, Finance Minister Michael Wilson stated:

> The alarming fact is that the mountain of debt inherited as a result of the string of deficits over the past 10 years requires ever-increasing interest charges on the debt. And these rising debt service charges are the driving force behind the continued pattern of high deficits and rising levels of debt. This means that with each year, more and more government money must be diverted from productive uses just to pay interest charges....The mounting debt burden and rising debt service charges pose a serious potential threat to the long-run growth of the economy.[6]

Four years later, the economy has grown by over 17 percent in real terms while the unemployment rate has dropped to 7.6 percent from 11.2 percent, yet progress on the fiscal front has been inadequate. The deficit remains in the $30 billion range. Net public debt is projected to surpass the $400 billion mark in fiscal year 1991–92 — one year later than the 1990–91 target date highlighted by the minister with alarm in his November 1984 statement.

If Canada is to face future challenges from a position of strength, it is essential to redress the federal fiscal imbalance with vigour now. There are many indicators of growing difficulty: the growing fraction of federal spending made up of interest payments; inflationary pressures and accompanying high interest rates;and a rapidly

rising foreign debt. The path that should be followed in addressing the fiscal problem is not difficult to find — what is needed is a firm commitment to follow it. Canadians must insist that the government make that commitment.

Notes

1 The potentially damaging effects of government deficits were set out in Neil Bruce and Douglas D. Purvis, *Evaluating the Deficit: The Case for Budget Cuts*, Policy Commentary 4 (Toronto: C.D. Howe Institute, 1984), pp. 8–10.

2 David A. Dodge, "Economic Objectives of Tax Reform" (Paper delivered to the Canadian Tax Foundation/John Deutsch Institute Conference on Tax Reform, October 7, 1987).

3 Net wealth formation refers to total capital formation — housing, plant, equipment, and inventories — minus the increase in Canada's net external liability.

4 All figures for saving and investment are net of capital consumption allowances. Statistical discrepancies have been allocated to private saving.

5 Edward A. Carmichael, Katie Macmillan, and Robert C. York, *Ottawa's Next Agenda*, Policy Review and Outlook, 1989 (Toronto: C.D. Howe Institute, 1989), pp. 108–113.

6 Hon. Michael H. Wilson, *A New Direction for Canada: An Agenda for Economic Renewal* (Ottawa: Department of Finance, Novem[illegible]er 1984), p. 19.

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